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ABSTRACT

It is the premise of this booklet, one of a series intended to apply economic principles to major social and political issues of the day, that a revolution in the banking and financial services industry is altering not only the fundamental nature of the services offered but the character of the organizations themselves. The purpose of the essay is to provide perspective on these important developments. It begins with a review of recent major changes in banking and financial services. The analysis concentrates on deregulation, although other aspects of the revolution are discussed, especially the growing competition from nonbank financial service firms and nontraditional financial service organizations such as Sears, Merrill Lynch, and American Express. Two major pieces of legislation crucial to these changes, the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Gart-St. Germain Depository Institutions Act of 1982, are discussed. In addition, the essay covers the implications of these changes for both consumers and producers of financial services and offers insight into the future structure of banking and the financial services industry. A glossary of key terms is provided at the end of the essay. (IS)

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PREFACE

A revolution is sweeping through banking and the financial services industry, and it is altering not only the fundamental nature of the services offered but the character of the organizations themselves.

It also is affecting the cost of financial services to consumers and the interest rates savers earn on their funds. Moreover, growing competition in the financial services industry and the rising incidence of failure are likely to substantially change the system of deposit insurance offered by the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC). The fundamental transformation of banking is often described by the term deregulation, although the dimensions of the revolution are much broader. In any case, the financial system of the United States, and the role of commercial banks in that system, will be very different in the future than it has in the past.

The purpose of this essay is to provide perspective on these important developments. It begins with a review of major recent changes in banking and financial services. The analysis concentrates on deregulation, although other aspects of the revolution are discussed, especially the growing competition from nonbank financial service firms and nontraditional financial service organizations such as Sears. The two major pieces of legislation that are significant in the revolution are considered: the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Depository Institutions Act of 1982. In addition, the essay provides an extensive treatment of the implications of the revolution for both consumers and producers of financial services as well as insight into the future structure of banking and the financial services industry. A glossary of key terms is provided at the end of the essay.

INTRODUCTION

The banking and financial services industry of the United States, and indeed of the entire world, has experienced remarkable change within the past few decades. A financial system characterized by relatively stable interest rates and fixed exchange rates, with specialized, segmented-service financial institutions has been replaced with one of volatile interest rates, sharply fluctuating exchange rates and dynamic innovation and competition among major financial institutions.

For example, the prime rate charged by commercial banks did not change at all for many years in the 1950s and early 1960s, yet the prime rate moved 13 times in 1981 alone. Similarly, the exchange rate between the U.S. dollar and the British pound remained constant for years throughout the 1950s and early 1960s, yet the value of the pound as compared to the dollar declined from $2.40/£ to $1.40/£ in the short period from 1981 to 1983.

Relatedly, the variety of financial services available from traditional financial service organizations such as commercial banks and savings and loans has exploded, while nonfinancial organizations have sought entry into the financial services industry: witness the attempt by Sears to induce consumers to buy their stocks where they buy their socks. The traditional categorization of financial institutions as shown in Figure 1 has become increasingly less relevant as financial service organizations become more and more alike.

These profound changes in the financial system reflect a variety of influences, including high and volatile inflation rates, rapid changes in technology that have both altered the cost of providing financial services and broadened the geographical area over which these services could effectively be delivered, as well as legislative initiatives that have come to be characterized as deregulation. (Although, in fact, the process has encompassed both deregulation and reregulation). The implications of these changes in the financial system are substantial for consumers of financial services, for those involved as managers and employees in the production of financial services and for the regulators of the nation's financial institutions such as the Federal Reserve and the Federal Deposit Insurance Corporation.

Three dimensions of this revolution are of special significance: deregulation, the growth of competition from nontraditional financial service organizations and the increasing overlap of services — often referred to as "blurring of functions" — among organizations that provide financial services. These developments are, of course, closely interrelated. In fact, the growth of competition from nontraditional financial service organizations and the increasing overlap of function represent principal causes of the deregulation of commercial banks and other depository institutions.

Deregulation

Deregulation in banking has three separate but closely related dimensions: *price deregulation* (especially deposit rate), *product deregulation*, and *geographic deregulation*.

Price deregulation refers to the lifting of legal restrictions on the interest rates that banks and other depository institutions (savings and loans, mutual savings banks and credit unions) may pay to obtain funds, and to a lesser extent, on the rates that may be charged for loans, commonly referred to as usury laws.

Product deregulation refers to the removal of the restrictions placed upon banks and other depository institutions in the types of services offered, such as investment services or insurance underwriting.

Geographic deregulation, of course, relates to the removal of limitations on the geographic extent over which banks (and other depository institutions) may operate deposit-taking facilities and encompasses the controversial issue of interstate banking.

Through early 1984, deregulation has focused primarily on price deregulation. In fact, virtually all restrictions on the rates that banks and other depository institutions could pay for funds were removed by late 1983, resulting in a proliferation of new deposit instruments, of which the money market deposit account is most notable. In contrast, product deregulation (at least for commercial banks) has been relatively limited -- while savings and loans have been allowed to broaden their services to consumers somewhat, the basic financial services offered by depository institutions in early 1984 were quite similar to those offered 10 or 20 years ago.

Action at the federal level to begin geographic deregulation has been most notable by its absence, though substantial action has taken place at the state level. Commercial banks and other depository institutions in early 1984 remained enmeshed in a web of regulation that generally limited their operations to one state and sometimes to one location within a given state. It now appears that nationwide, interstate banking will begin through regional compacts among states rather than through alteration of federal laws, reflecting the reluctance of the U.S. Congress to deal with the issue.

Competition From Nontraditional Organizations

Many new organizations have begun to offer financial services in direct competition with banks, savings and loans and other traditional financial service organizations. Perhaps the best example of the competition from nondepository financial institutions is offered by Merrill Lynch. **Figure 2** presents a list of financial services offered by the nation's largest brokerage firm. These include a full range of securities services, as well as insurance, real estate lending and brokerage and employee relocation services. It is important to note that many of these services are directly competitive with commercial banks. For example, Merrill Lynch offers credit for real estate and related purposes and for the purchase of securities. Moreover, with its Cash Management Account (CMA), Merrill Lynch has created a financial

Types of Financial Service Organizations

Depository Institutions

Commercial Banks
Savings and Loans
Mutual Savings Banks
Credit Unions

Contractual Institutions

Life Insurance Companies
Property and Casulty Insurance Companies
Pension Funds

Other Financial Institutions

Money Market Funds
Other (non-money market) mutual funds
Finance Companies
Real Estate Investment Trusts
Leasing Companies
Mortgage Bankers
Security Brokers and Dealers

Figure 1

instrument that is directly competitive with checking accounts offered by depository financial institutions. Yet Merrill Lynch is able to offer investment banking and insurance services to customers, functions traditionally prohibited to commercial banks.

The money market mutual fund provides another example of the growth of new sources of competition. A money market fund is a mutual fund which invests in short-term, high-quality money market instruments such as Treasury bills, commercial paper, and bankers' acceptances. Less than 10 years old, money market funds have grown enormously, as shown in **Table 1**. Total assets exceeded $200 billion by late 1982 (more than three times the total assets accumulated by the entire credit union industry in its history) and represented more than 10 percent of total household deposits.

Money market funds originated in the early 1970s to offer the small saver a market rate of interest at a time when the rates available at depository financial institutions were limited by federal regulation, commonly referred to as Regulation Q. Moreover, many money market funds offer a number of convenient services that have proven attractive to savers. Perhaps the most significant of these is the ability to write checks against the value of the account. To a considerable degree, the reduction in interest rate ceilings and the widening of the authority to offer checkable deposits allowed depository institutions to respond to the financial pressures created by the growth of money market funds.

Overlap of Functions

Figure 3 provides a list of financial services offered by depository (bank and savings and loans) and nondepository institutions in 1960 and in 1984, illustrating the enormous growth in competition among these organizations. As shown, the financial services offered by commercial banks in 1984 remained very similar to those provided in 1960 — checking accounts, saving and time accounts, installment loans, business loans, mortgage loans and credit cards. But the powers of savings and loans have broadened somewhat. For example, savings and loans in 1984 were able to offer checking accounts and more diversified types of credit than in 1960. In terms of credit granting powers, the most significant change at savings and loans has been the ability to offer all types of consumer credit.

Services Offered by Merrill Lynch and Co.

Securities Services

Broker and Dealer
Commodity Futures and Options Broker
Security Underwriting
Investment Banking
International Merchant Banking
Leasing
Dealer in U.S. government and government agency securities and in money market instruments
Margin Lending
Securities Research
Investment Counseling
Sale and Management of Mutual Funds
Cash Management Account

Insurance Services

Mortgage Cancellation Life Insurance
Other Life Insurance
Annuities
Insurance to real estate lenders against default risk
"Directed" Life Insurance

Real Estate and Related Services

Real Estate Financing
Mortgage Banking
Real Estate Management Services
Brokerage
Employee Relocation

Source: Merrill Lynch and Co.

Figure 2

Financial Services Offered by Depository and Non-Depository Institutions (1960 and 1984)

	Banks		Savings and Loans		Insurance Companies		Retailers		Security Dealers	
	1960	1984	1960	1984	1960	1984	1960	1984	1960	1984
Checking	✓	✓		✓		✓		✓		✓
Savings	✓	✓	✓	✓		✓		✓		✓
Time Deposits	✓	✓	✓	✓		✓		✓		✓
Installment Loans	✓	✓		✓		✓		✓		✓
Business Loans	✓	✓				✓		✓		✓
Mortgage Loans	✓	✓	✓	✓		✓		✓		✓
Credit Cards		✓		✓		✓	✓	✓		✓
Insurance					✓	✓		✓		✓
Stocks, Bonds Brokerage		✓		✓		✓		✓	✓	✓
Underwriting									✓	✓
Mutual Funds						✓		✓	✓	✓
Real Estate				✓		✓		✓		✓
Interstate Facilities		✓		✓		✓		✓		✓

Source: Donald L. Koch, "The Emerging Financial Services Industry: Challenge and Innovation," Federal Reserve of Atlanta, *Economic Review*, April 1984, p. 26.

Figure 3

The most remarkable change illustrated by Figure 3 is the extraordinary expansion in financial services offered by insurance companies, retailers and securities dealers. By 1984, these nondepository institutions could offer virtually every financial service that banks and savings and loans could provide. Yet banks and savings and loans were not able to offer many of the services provided by these nondepository institutions. Not surprisingly, the depository institutions have complained bitterly about inequality of regulation and continue to press Congress for legislation that would broaden both the financial services they provide (product deregulation) and the geographical area they can provide them in (geographical deregulation).

Causes of the Financial Revolution

A large number of pressures that have been building for many years may be pointed to as basic causes of the revolution in banking and the financial services industry. To a considerable extent these factors are interrelated, so to understand the significance of any one cause it is necessary to view them all. The following list is reasonably comprehensive.

The thrift problem. Thrift institutions in general and savings and loans and mutual savings banks in particular were experiencing considerable financial difficulties, with the threat of literally an avalanche of failures if interest rates remained at historically high levels. The thrifts were confronted with almost constant returns on their asset portfolio of long-term fixed rate mortgages at the same time that the costs of their deposit funds were rising sharply. As a result, many thrifts were experiencing major losses in the late 1970s and early 1980s, losses that raised the possibility of the collapse of the industry.

Table 1

Assets of Money Market Funds
1973 - 1983
(Billions of Dollars)

Year	Total Assets	Percent of Household Deposits
1973	—	0
1974	2.4	0.3
1975	3.7	0.4
1976	3.7	0.3
1977	3.9	0.3
1978	10.8	0.8
1979	45.2	3.1
1980	74.4	5.1
1981	181.9	N.A.
1982	206.9	N.A.
1983	176.2	N.A.

Note: 1983 data are as of the end of the second quarter.

Sources: Board of Governors of the Federal Reserve System *Flow of Funds Accounts*

The Regulation Q problem. Limitations on the interest rates payable by depository institutions to attract funds — usually referred to Regulation Q ceilings — were causing increasing difficulties as interest rates increased. Banks and other depository institutions were unable to offer competitive rates on their deposits and hence lost funds to other competitors, a process known as *disintermediation*. These interest-rate limitations gave rise to a wholly new industry in money market funds. Ironically, the growth of money market funds has, in turn, contributed to the ultimate demise of interest rate ceilings, and perhaps even to the eventual demise — or at least substantial shrinkage — of the money market funds. While depository institutions — especially commercial banks — did innovate around these ceilings to some extent, the attempts were costly and only partially successful.

The Fed membership problem. Concerned about the continuing withdrawal of member banks from the Federal Reserve System because of a higher reserve requirement for member than for nonmember banks (state chartered banks may withdraw from the Federal Reserve but national banks may not), the Fed attempted throughout the 1970s to have legislation passed that would force all banks to become members of the Federal Reserve System. While such attempts failed, the Fed did essentially achieve its purpose through the 1980 legislation that mandated uniform reserve requirements for all depository institutions.

The need to create equality of regulation. To the extent that depository institutions were becoming increasingly alike in function — and this was happening well before the recent legislation — the existing system of regulation was becoming less and less defensible. Unequal reserve requirements, for example, are difficult to justify for closely competing institutions: For example, reserve requirements were not equal with credit unions which had no reserve requirements, and nonmember banks had lower reserve requirements than member banks.

Technological change. The amazing pace of technological change — especially that group of services that collectively is referred to as electronic banking — was making the traditional boundaries between commercial banks and other depository institutions obsolete and was permitting easy and less costly access into the financial services industry by new firms. In fact, it may be argued that the development of the 800 toll-free number and its use by financial service organizations (the money market fund is the best example) represents a fundamental change in the nature of competition in the financial services industry.

The growth of nondepository institutions. The traditional markets served by depository institutions had been invaded by nondepository institutions. Some of these institutions were financial in nature — witness the expansion of services offered by Merrill Lynch or the Prudential-Bache affiliation — while others, such as Sears and National Steel, were previously nonfinancial in nature.

High and volatile interest rates. Interest rate movements during the 1970s and early 1980s were unprecedented in their levels and volatility. For example, the prime rate (the rate charged by commercial banks to their best customers) increased from 5 percent in 1972 to 12 percent in 1974. It then declined to under 10 percent in 1976, only to rise to 20 percent in 1980 and 1981. Both the rises in and the volatility of these rates placed great pressure on the financial condition of many banks and savings and loans and indeed threatened to destroy the viability of the savings and loan industry, which traditionally had concentrated in fixed-rate, long-term residential mortgages.

More sophisticated customers. Related to these factors is the sharp increase in the sophistication of many consumers of financial services. Spurred by rising wealth and education levels, heads of households have been much more adept at managing their funds. Growing sophistication in funds management also is characteristic of corporate treasurers.

All of these affected the ability of commercial banks and other depository institutions to compete effectively in the increasingly homogenized financial services industry. The competitive position of depository institutions appeared to be declining within the industry. Congress was faced with the choice between increasing the regulation of non-depository institutions or reducing the regulation of depository institutions. Fortunately it chose the latter, though that choice itself creates problems of its own.

Highlights of Legislation

Before turning to consideration of some of the consequences of deregulation it may be desirable to discuss the highlights of the principal legislation that has been a part of the financial services revolution. The two relevant statutes are the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Depository Institutions Act of 1982. It is important to note that the reforms contained in these two laws had been proposed in almost identical form by numerous study groups throughout the 1970s. However, it was not until pressures created by the thrift crisis and the accelerating pace of technological change in the late 1970s that Congress was able to pass such legislation. It also is significant to note that the various regulatory agencies for depository institutions — the Federal Reserve, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Federal Home Loan Bank Board — allowed the institutions subject to their regulation greater flexibility in their operations throughout the 1970s. A chronology of legislative and regulatory developments from 1972-1982 is provided in **Figure 4**.

The 1980 Depository Institutions Deregulation and Monetary Control Act provided, among other things, for the following:

(1) **Uniform Reserve Requirements.** All depository institutions will be subject to the same reserve requirements when the Act becomes fully

Regulatory Developments

1972 NOW accounts were authorized for thrift institutions in Massachusetts. In the next few years, all New England thrifts were allowed to issue NOWs.

1973 The wild card experiment: The first use of ceiling-free, small denomination certificates of deposit. The certificate had a minimum maturity of four years; the experiment lasted four months. All depository institutions were allowed to participate.

1975 California state-chartered savings and loans were authorized to issue variable-rate mortgages. At the same time, a few national banks in California began to issue variable-rate mortgages.

1978 6-month money market certificates were authorized nationally for all depository institutions. California federally-chartered savings and loans were authorized to issue variable-rate mortgages.

1980 Authorization of the 2½-year small saver certificate for all depository institutions. Passage of the DIDMCA:

- Extension of reserve requirements to all depository institutions.
- Creation of the Depository Institutions Deregulation Committee.
- Allowed thrifts to invest 20 percent of assets in consumer loans.
- Allowed mutual savings banks to make business loans and accept business deposits.

1981 Introduction of nationwide NOW accounts.
Introduction of the ceiling-free Individual Retirement Account.
Introduction of the tax-exempt All Savers certificate deposit.

1982 Several new accounts paying market-related rates were introduced:

- 91-day money market certificate.
- 3½-year ceiling-free deposit.
- 7-to-31 day time deposit.

Passage of the Garn-St. Germain Act:

- Capital assistance for ailing thrifts.
- Authorization of the money market deposit account.
- Increase allowable consumer loan percentage at thrifts to 30 percent.
- Authorized savings and loans to issue business loans and accept business deposits.

1983 Introduction of the Super NOW accounts.
Lowering of minimum deposit on short-term certificates of deposit to $2,500.
Elimination of ceiling rates on remaining time deposits.

Source: Daniel J. Vrabac, "Recent Developments at Banks and Nonbank Depository Institutions." Federal Reserve Bank of Kansas City *Economic Review*, July-August, 1983, p. 33.

Figure 4

implemented; only size and type of deposit will be relevant in determining reserve requirements.

(2) **Fed Services.** Services provided by the Federal Reserve such as check clearing and providing vault cash must be offered to all depository institutions and must be priced based upon the Fed's production costs plus a "normal" profit margin. Prior to passage of the legislation the Fed provided its services only to member banks and then generally without explicit cost.

(3) **Regulation Q.** The legislation began the process of eliminating interest rate ceilings on deposit accounts at all depository institutions. It created the Depository Institutions Deregulation Committee with instructions to phase out interest rate ceilings and to eliminate those ceilings completely no later than March 1986. This reduction in deposit-rate ceilings was gradual, beginning in 1981, though by late 1983 almost all deposit-rate ceilings had been removed.

(4) **Negotiable Orders of Withdrawal (N.O.W.) Accounts.** The legislation authorized all depository institutions to offer interest bearing transactions accounts. For the first time on a nationwide basis, the traditional monopoly by commercial banks of transactions (i.e., checking) accounts was broken. Also, for the first time in almost 50 years, explicit interest payments on transactions accounts were allowed.

(5) **Savings and Loans.** The lending powers of savings and loans were broadened with passage of the 1980 legislation. In particular, savings and loans were allowed to commit a substantial part of their assets to consumer loans. They were also given trust powers. The reforms of the powers of savings and loans contained in this legislation went a long way toward the creation of a "department store of family finance" in the form of savings and loan associations.

Turning to the **Garn-St. Germain Depository Institutions Act of 1982,** the provisions of this legislation may be viewed in some respects as dealing with the problems that had not been resolved in 1980. That earlier legislation had attempted to deal with the thrift institutions problem and to provide for a gradual elimination of Regulation Q ceilings. By 1982 the thrift institutions problem had become a thrift institutions crisis, and it was becoming apparent that with the extraordinarily high interest rates of 1981-82, a more rapid lifting of interest rate ceilings was necessary.

As a result, the bill provided for:

(1) **FDIC/FSLIC assistance for floundering and failing institutions.** In

past years, the regulatory agencies had been constrained in arranging the purchase of a floundering or failing institution by restrictive laws on interstate acquisitions of depository institutions. The 1982 legislation allows for interstate acquisition of failing institutions according to the following priority schedule: a) same type institution, same state; b) same type institution, different state; c) different type institution, same state; d) different type institutions, different state.

For example, if the failing institution was a commercial bank in Texas, the first potential acquirer would be another bank in Texas, the second potential acquirer would be a commercial bank located outside of Texas, the third potential acquirer would be another type of financial institution in Texas, and the fourth potential group of acquiring institutions would be another type of financial institution located outside of Texas.

(2) **Net Worth Certificates.** The 1982 legislation provides for an exchange of debt (called net worth certificates) between depository institutions and the regulatory agencies. While of substantial legal significance in maintaining an adequate capital position for floundering and failing depository institutions, the economic importance of this portion of the 1982 legislation was relatively minor.

(3) **Additional Thrift Institution Restructuring.** Savings and loans and other thrifts were given even greater powers to offer deposit-taking and lending services. Savings and loans were permitted to offer demand deposit services to qualified commercial, corporate and agricultural customers, as well as to expand their consumer lending and to engage in a limited amount of commercial lending.

(4) **Money Market Deposit Accounts.** Perhaps the most significant feature of the 1982 legislation was the provision instructing the Deregulation Committee to create (within 60 days) a money market deposit account equivalent to and competitive with money market mutual funds. The Deregulation Committee did create such an instrument, effective in December 1982, as well as the super N.O.W. accounts effective in January 1983. The money market deposit accounts have been phenomenally successful, attracting over $300 billion by mid-1984.

These remarkable changes in the financial services industry have not occurred in a domestic vacuum. They are a part of a worldwide trend that is changing the basic functions of financial institutions. Developments in one country obviously have important implications for developments in another.

Consequences of the Revolution in Banking and the Financial Services Industry

Given this legal and regulatory background, it is important to examine some of the major consequences of this revolution.

Functions of Depository Institutions. It appears highly likely that this

revolution will result in a marked change in the functions of individual financial institutions. Certainly savings and loans associations will become more like commercial banks. (Great Britain currently provides an excellent example of this merging of function between thrifts and commercial banks.) Whether this merging will ever result in total overlap of services is questionable, though, because savings and loans appear to have some comparative advantage in the origination of mortgages and mortgage related credit, and commercial banks possess a corresponding advantage in commercial lending.

At the same time that depository institutions are becoming more alike in their deposit-taking and credit-providing services, the depository institutions will become like other financial service firms. For example, the division between commercial banking and investment banking is rapidly being eroded. Entry by commercial banks into the discount brokerage business provides tangible evidence of this erosion. Unless checked by additional and more restrictive legislation it appears likely that these functions will merge in the near future. The rapid rate by which the gap between commercial and investment banking is closing validates the adage "bankers can innovate faster than regulators can regulate."

One potential outcome of the revolution in banking and the financial services industry is shown in **Figure 5**. According to this view, which is only one of a variety of possibilities — though a quite plausible one, the financial services firm of the future may be one of three types.

One would be a financial supermarket that would distribute a wide variety of financial services throughout the nation or internationally. This group of firms (which might number as few as 8-10 organizations) would include the largest banks like Citicorp or Bank of America as well as large nonbank organizations such as Merrill Lynch, American Express and even Sears.

Future Banking Structure

	Type of Organization		
	(1) National Distribution	(2) Low Cost Producer	(3) Specialty Firm
Money Center Banks	*		*
Regional Banks			*
Local Banks			*
New Entrants		*	
Nonbank Financial Institutions	*	*	

Figure 5

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A second group of institutions might be low cost producers of selected financial services, analogous to the discount brokerage firms. These would likely be new entrants using the latest electronic technology. Finally, and largest in terms of number, would be various firms concentrating in selected portions of the market to serve particular "niches." These would include smaller banks as well as a number of other financial institutions.

Prices and availability of financial services. Certainly the movement toward financial deregulation will affect the price and availability of financial services — to the benefit of most, but not all, consumers. With elimination of Regulation Q ceilings, consumers can expect to receive market rates of interest on their deposits. Similarly, greater competition in the credit market should produce greater credit availability at lower cost. At the same time, some consumers of financial services — those that have not been paying their own way — will be made worse off by deregulation as depository institutions raise their prices. Low deposit balance customers that make large use of bank services will be losers as a result of the revolution while those with more substantial means will benefit greatly.

Geographic Expansion. The remarkable changes occurring in the financial services industry have substantial implications for the geographic expansion of depository institutions, especially for commercial banks that have been particularly affected by legislative restraints on geographic expansion. The geographic area over which depository institutions will be able to offer their products has expanded and is likely to expand even more in coming years.

A very substantial amount of interstate operations by depository institutions already exists in a variety of forms. For example, a number of bank holding companies already operate banking subsidiaries in more than one state. Most of these organizations had operated interstate prior to the passage of restrictive legislation and were allowed to continue their operations under "grandfather" clauses in the restrictive legislation. For example, First Interstate Bancorporation operates banking subsidiaries in 11 western states while Northwest Bancorporation operates banking subsidiaries in 7 states. Similarly, many savings and loan associations operate in more than one state. For example, as of March, 1983, Home Savings Association of America operated in California, Florida, Illinois, Missouri and Texas.

Even more significant evidence of the interstate operations of banking organizations is provided by an analysis of the nonbanking activities of bank holding companies, such as leasing and consumer finance. In contrast to the bank subsidiaries of bank holding companies that are restricted to one state, bank holding companies may operate their nonbank subsidiaries without geographic restraint. As of 1981, Manufacturers Hanover had 471 nonbank subsidiary offices located outside of New York State. Security Pacific had 427 nonbank subsidiary offices located outside of California, the state in which its banking subsidiaries are located.

Additional information on the interstate operations of the nonbank subsidiaries of bank holding companies is provided by looking at their geographical location. For example, of the 10,964 nonbank subsidiaries of bank holding companies, over 5,000 are located outside of the parent state. Most of these interstate activities are concentrated in finance company offices. In fact, over 4,000 finance company offices are located outside the state in which the parent resides, accounting for about 80 percent of all interstate offices of nonbank subsidiaries of bank holding companies. The largest number of these offices are located in California (434), Pennsylvania (297), Florida (281) and Texas (243).

The total number of interstate offices of out-of-state banking organizations approached 8,000 in 1982, and about 70 percent were interstate offices of nonbank subsidiaries of bank holding companies. The states with major out-of-state banking activity included California (787 offices) and Florida (621 offices). Clearly, interstate banking already exists to a considerable degree.

While many banking organizations have *circumvented* the barriers to geographical expansion, progress toward actual removal of these barriers has been relatively slow. In terms of *intrastate* barriers, a few states, including Illinois, Florida, Nebraska, Oklahoma and Arkansas, have recently reduced their restraints on geographical expansion of banking organizations. On an *interstate* basis, a number of states have recently passed legislation allowing out-of-state banking organizations to enter. For example, Alaska permits acquisition of existing banks by out-of-state bank holding companies. Delaware allows acquisition of a single office, limited purpose new bank with an initial capitalization of $40 million. South Dakota allows entry by out-of-state banks on terms similar to those of Delaware. Also, the six New England states have recently enacted reciprocal legislation that allows banks headquartered in any of the New England states to acquire other banks located throughout the region. This type of regional banking may indeed provide the model for interstate banking of the future.

While economic, financial and technological forces are clearly breaking down the barriers to interstate banking — and also to additional intrastate expansion in these states that continue to restrict such expansion — the movement to full interstate banking may take considerable time. There are, of course, substantial political pressures from some special interest groups aimed at preventing the reduction or elimination of barriers to geographical expansion by banking organizations. Even if these political pressures were overcome, and it seems certain that they will be at some point, the question remains as to how rapidly banking organizations would actually proceed with interstate expansion. In this regard, it should be remembered that many banking organizations already have an interstate presence through nonbanking subsidiaries and through other means.

Despite these considerations, however, it seems likely that full interstate banking with some truly national organizations eventually will come to

pass. The manner in which such expansion will occur is also uncertain. At present, it appears that interstate banking will occur when state legislatures allow reciprocal branching or create regional banking zones, such as in New England. Yet it is also possible that the U.S. Congress may change the laws allowing bank holding companies to acquire banks anywhere in the U.S. or to allow branch banking on an interstate basis.

Product Line Expansion. Related to the ability of commercial banking organizations to expand geographically is their ability to increase their product offerings to the public. Through 1983, at least, most of the expansion of product lines focused on thrifts. In an effort to make them economically viable, savings and loans and other thrifts were permitted to offer products that traditionally had been limited to commercial banks. Similarly, nondepository financial institutions and certain nonfinancial institutions had entered into direct competition with banks by offering bank-like products. The best examples of this new competition are Merrill Lynch, American Express and Sears, although there are many others.

The expansion in product line offerings permitted for commercial banks in this revolutionary era has been relatively slight through early 1984. Probably the most significant new product permitted the commercial banking industry is the money market deposit account, although the reduction in Regulation Q ceilings generally may be viewed as giving banks a greater, or at least more competitive, span of product offerings. But the banking industry has increasingly sought to test the limits of its legal authority to offer new products and at the same time to effect legislative changes that would allow them to offer a wider product mix.

Perhaps the best example of banking organizations seeking new product lines is expansion into discount brokerage. This industry itself was created by the deregulation of exchange commission rates in the mid-1970s. However, it was not until the early 1980s that banks began to offer discount brokerage services to their customers either through the acquisition of existing discount brokerage firms (such as Bank of America's acquisition of Charles Schwab and Chase Manhattan's acquisition of Rose and Co.) or by starting new firms, in which case most of the execution of the transaction was placed through an existing firm.

The entry of banking organizations into discount brokerage is their first step into the securities business. Such a step was justified legally on the ground that the discount broker offers only execution of transactions, a function that some banks had provided for their customers for many years. Because it does not involve the underwriting or distribution of securities, it is argued, the action does not violate the separation of commercial and investment banking provided for in the Glass-Steagall Act. In fact, the banking industry has pressed Congress to modify or eliminate such divisions between investment and commercial banking, giving banks full authority to underwrite and distribute all types of securities.

Profitability and the number of depository institutions. If the expectation of greater competition, higher deposit rates and lower loan rates is realized, then there should be substantial pressure on the profitability of depository institutions. While spreads (i.e., the difference between earnings on assets and the cost of funds) should fall with growing competition for deposits and loans, it is not at all clear what the magnitude of the decline in profitability will be. It may be, for example, that declining spreads will be more than offset by more efficient operations in other areas.

In past years, restrictions on competition produced by regulation should have resulted in reduced efficiency and higher cost in providing financial services. Growing competition associated with less regulation should, to some extent at least, reverse this process. Also, it is likely that financial institutions will attempt to offset declining spreads by raising fees for services, such as stopping payment on a check. In fact, bank fee income has increased dramatically in the early 1980s.

To the extent that profitability is reduced by growing competition, however, the number of independent depository institutions should shrink, as high cost firms find it impossible to make an acceptable profit. The pricing flexibility offered to managers of depository institutions may also contribute to this reduction in the number of institutions. Under deregulation, managers of depository institutions have greater flexibility in making decisions, greater opportunity to make correct — and incorrect — decisions. Some of these incorrect decisions will result in failure of the organization, thereby reducing the number of independent entities.

It thus appears likely that there will be consolidation among depository institutions. However, there remains the question of the extent of such consolidation. For example, the extent of consolidation may be quite different for commercial banks compared to savings and loans. Also, an important question remains as to the structure of the depository institutions industry after the consolidation is complete.

There are a number of different estimates of the ultimate degree of consolidation. For example, one estimate is for a potential decline in the number of commercial banks of from 30 to 50 percent. This would leave roughly 7,000 to 10,000 commercial banks in the United States, though fewer independent entities. In contrast, consolidation among savings and loans would be less substantial (in view of the pre-deregulation consolidation that has already occurred) so that the number of savings and loans may shrink only by about 10 percent.

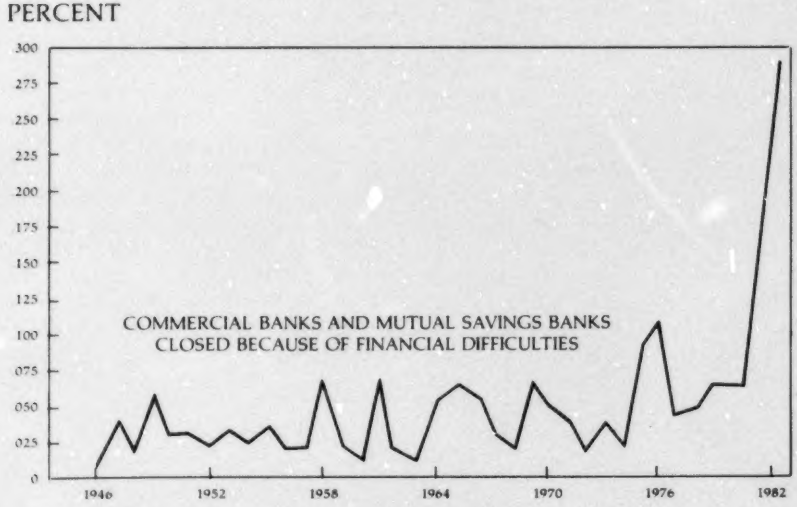
This scenario does not imply that small community banks cannot survive in a deregulated environment. Given the evidence that economies of scale in providing most financial services are quite limited, any cost disadvantages of community banks (and thrift institutions) are likely to be quite small. As long as financial services remain highly personal in nature, the ability of well-run community organizations to survive and prosper does not appear to be threatened. It seems highly unlikely that the financial

system of the United States will ever resemble that of England or Canada, in which less than 10 banks control most of the market.

Depository Institutions Failure. With diminishing profit margins and growing competition, and with increased management discretion permitting managers to make greater mistakes, the incidence of failure should rise. In fact, as shown in **Figure 6**, the incidence of failure has already increased substantially. The number of failures also will be greatly affected by the stability of the economy and interest rates levels.

If the failures are limited to small institutions, the effects on the financial system should be small. However, if — as appears likely — large depository institutions fail, the resulting effects on the financial system could be more serious. Indeed, the failure of the First National Bank of Midland (Texas) in 1980 (the third largest bank failure in U.S. history) and the rescue in May 1984 of the Continental Illinois National Bank of Chicago (the eighth largest bank in the United States) has produced great concern about the stability of the financial system. Failures of large organizations will undoubtedly place great pressure on the federal deposit insurance system.

Bank Failures as a Percentage of All Banks



Source: Eugenie D. Short and Gerald P. O'Driscoll, Jr., "Deregulation and Deposit Insurance," Federal Reserve Bank of Dallas *Economic Review*, September 1983, p. 13.

Figure 6

Deposit Insurance. Closely related to the topic of bank failures (and failures by other depository institutions) is the entire subject of deposit insurance. Indeed, the deposit insurance funds of the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) have been severely strained by the upsurge in the number, and particularly the total assets, of failing institutions. Whether the rising failure rate in the period from 1981 through 1984 is attributable to deregulation and the revolution in the financial services industry is difficult to discern, although it probably has more to do with the severe economic contraction of the period and volatile interest rates than with deregulation.

Deposit insurance, deregulation and the revolution in financial services are, however, closely and inextricably linked. One recent study argues that to deregulate banks and other depository institutions without reforming the present system of flat rate deposit insurance is putting "the cart before the horse."

To a considerable extent, deposit insurance removes the discipline of the market from bank portfolio behavior. Without deposit insurance, banks that accepted greater risk in their portfolios would find that their costs of funds would rise; potential increases in costs of funds (in a world without deposit insurance) would thus constrain the risk that banks (and other depository institutions) would be willing to take in their portfolios. In contrast, with deposit insurance, more risky portfolios do not necessarily elicit rising funds costs since depositors (or at least insured depositors) are not at risk if the bank fails. The FDIC or FSLIC is at risk, not the depositors. Traditionally the deposit insurance agencies have dealt with this problem through constraints on portfolio behavior that limits bank risk — the deposit insurance agencies sell *two* products, insurance and regulation. Yet with greater bank portfolio management flexibility, the ability of the insurance agencies to control bank portfolio risk is sharply reduced.

It thus appears that the revolution in the financial services industry has created a fundamental problem for deposit insurance as it is presently designed. This problem will, of course, become more significant if the revolution continues. Further, these developments make it likely that the deposit insurance system will be fundamentally altered.

The FDIC itself has proposed a system of insurance charges based on the risk of the insured bank. Under this proposal, any bank that had greater than normal portfolio risk would have higher deposit insurance costs. Another proposal is to incorporate co-insurance into the deposit insurance system, such that depositors, especially large denomination depositors, would receive some but not all of their funds back in the event of a bank failure. In fact, the FDIC did follow this policy in dealing with two bank failures (one in Texas and the other in California) in early 1984. There are a number of other proposals, most of which seek to restore market discipline

to bank costs. Which of the proposals ultimately is adopted may depend as much on political as economic factors, although change in the present deposit insurance system seems inevitable.

Reform of the Regulatory Structure. The existing system of regulation of depository institutions is highly complex and reflects the historical evolution of the institutions. For example, at the federal level, there are three agencies that deal with bank regulation: the Comptroller of the Currency (a part of the U.S. Treasury Department), the FDIC and the Federal Reserve. Fortunately, the federal regulation of savings and loans and credit unions is less complex. The Federal Home Loan Bank and its subsidiary the Federal Savings and Loan Insurance Corporation deal with savings and loans, and the National Credit Union Administration deals with credit unions. However, in many cases, federal regulation is shared with state regulation.

As depository institutions become more alike, it becomes less and less reasonable to have overlapping federal regulatory agencies. It thus appears reasonable to expect some consolidation among the regulatory agencies. One step in that direction may be the merging of the FDIC and FSLIC insurance funds. But more fundamentally, it seems reasonable to expect that the regulatory functions of the Federal Reserve will at some point be merged with those of the FDIC, the Comptroller of the Currency, the FSLIC and the National Credit Union Administration. What the resulting agency may be like is uncertain, although its shape will most likely be determined as much by political as by economic considerations. In fact, the recent recommendations of Vice President George Bush's task force on regulatory reform — which included the creation of a new federal bank regulatory organization — appears to reflect political factors as much or more than economic ones.

Summary and Conclusions

The revolution in banking and the financial services industry has already dramatically altered the nature of the U.S. financial system. The combination of unstable economic and financial conditions, rapidly changing technology, more sophisticated consumers of financial services and basic changes in the legislative and regulatory environment have produced a banking and financial services industry that is drastically different than that which existed just a few years ago. Yet the revolution is not complete; the changes are not complete. Further advances in technology are almost certain to occur, as are further changes in the demands for financial services. These economic factors will almost certainly produce additional legislation that extends the reforms embodied in the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Gart-St. Germain Depository Institutions Act of 1982.

As with any radical and rapid change in the nature of an industry, both benefits and costs are involved. There will be winners and losers among the financial institutions themselves and among the consumers of financial services. Some financial institutions will prosper as they meet demands for financial services in a cost-efficient way. Similarly, new organizations will enter the industry, offering low cost financial services with the latest technology. In contrast, some financial institutions that fail to adapt to new competitive pressures will cease to exist. Many will simply fail and it appears likely that a higher (perhaps much higher) failure rate among financial service organizations will be a significant cost of the revolution. Other weakened institutions will be absorbed by stronger organizations, contributing to the consolidation of the industry. The pressures placed upon the deposit insurance system may be intense, perhaps resulting in the reform of the deposit insurance system itself.

Consumers should be the principal beneficiaries of the financial revolution, just as consumers are the ultimate beneficiaries of growing competition in any industry. The ability of consumers to obtain market (i.e., higher) interest rates on their time and savings accounts since the dismantling of Regulation Q interest rate ceilings in late 1983 is only one example of the benefits that have been produced by financial reform. In addition, the growing competition among financial service organizations should produce the greatest possible quantity of financial services at the least possible cost. In fact, the proliferation of different types of financial services that has accompanied the financial revolution has already provided consumers with a much wider variety of services. Unconstrained by regulation, financial service organizations will be able to innovate new products to meet consumer demand.

But the benefits to consumers are not free. For consumers who were not paying the full cost for their services (low balance depositors are one example), the cost of financial services will and already has risen. Also, the proliferation of financial services with different cost and convenience characteristics will make it more important for consumers to investigate the alternatives available to them, requiring more time and research to obtain the necessary information. In addition, to the extent that the deposit insurance system is changed, depositors may have to be more careful about the financial health of the institution in which they leave their funds. Yet these costs seem small as compared to the potential benefits that flow from the financial revolution.

Glossary

Checkable (transactions) deposits: Those deposits that may be transferred by check or other similar means. These include demand deposits, Negotiable order of withdrawal (NOW) accounts, super NOWs and share drafts (principally at credit unions). Demand deposits may be offered to any type of customer although they pay no explicit interest. NOW accounts pay interest although they may be offered only to individuals and non-profit organizations. The powers granted to thrift to offer checkable deposits has focused on NOW accounts.

Depository Institutions: All financial institutions that offer **deposits**. The term is usually restricted to commercial banks, savings and loans, mutual savings banks and credit unions, although a case could be made that money market mutual funds should be considered depository institutions since they offer securities that are highly substitutable for deposits in the portfolio of consumers, businesses and governments. Deposits insurance relates only to depository institutions, not to money market mutual funds. Nonbank depository institutions are often referred to as thrifts due to their traditional orientation toward gathering savings deposits from the public.

Depository Institutions Deregulation and Monetary Control Act of 1980: The first major piece of financial reform passed by the U.S. Congress in almost 50 years and the beginnings of statutory deregulation of depository institutions. Among other things, the legislation provided for gradual elimination of Regulation Q deposit-rate ceilings for all depository institutions and broadened the products that thrifts could offer by allowing them to provide checking accounts and to make a broader variety of loans. The legislation also sought equality of regulation among depository institutions by providing for equal reserve requirements for all depository institutions. It also stipulated that Federal Reserve services must be provided to all depository institutions, although on an explicit fee basis.

Depository Institutions Deregulation Committee: A federal agency created by the Depository Institutions Deregulation and Monetary Control Act of 1980 with instructions to gradually phase out Regulation Q deposit rate ceilings. All ceilings must be eliminated by March 1986. In fact, most ceilings were eliminated by late 1983.

Deposit Insurance Agencies: The Federal Deposit Insurance Corporation insures commercial banks and some mutual savings banks. The Federal Savings and Loan Insurance Corporation insures savings and loans. The National Credit Union Administration insures credit unions. Each of those agencies has been under great pressure as the result of a sharp increase in the number of failures of depository institutions. Important questions exist as to whether the revolution in banking and the financial system has made the existing system of deposit insurance unworkable.

Garn-St. Germain Depository Institutions Act of 1982: The second piece of reform legislation providing for the deregulation of depository institu-

tions. Among other things, it essentially completed the process of eliminating Regulation Q deposit-rate ceilings, allowed for creation of a deposit instrument fully competitive with money market mutual funds in the form of money market deposit accounts and further broadened the powers of thrift institutions. It also included a number of provisions designed to temporarily aid the thrift industry.

Geographic Deregulation: The removal of restraints on the geographic area over which a depository institution may offer financial services. The McFadden Act (1927) prohibits interstate branching while the Douglas Amendment (1956) to the Bank Holding Company Act prohibits interstate acquisitions of banks by bank holding companies unless specifically authorized by the individual state. Each state also has its own statutes relating to the intrastate area over which banking organizations may operate.

Glass-Steagal Act (1933): This legislation separated commercial banking from the securities business by prohibiting commercial banks from dealing in corporate securities, while investment banks were prohibited from offering demand deposits. This separation of allowable activities effectively limited competition among types of financial institutions.

McFadden Act (1927): This federal legislation specified that national banks must follow the branching restrictions established by the state in which the national bank operated. The act effectively prohibited interstate branching by establishing the authority of individual states to determine their own banking structure. Because the state boundary became the ultimate geographic limit for branch banking, the act effectively insulated in-state banks against competition from out-of-state banks.

Money Market Deposit Account and Super N.O.W.: Two new deposit instruments designed to allow depository institutions to compete more effectively with money market mutual funds, securities dealers and others. Authorization for the accounts was given by The Depository Institutions Deregulation Committee under the Garn-St. Germain Depository Institutions Act of 1980. Both carry a $2,500 minimum and have no rate ceiling. The MMDA has limited checking while the super N.O.W. has unlimited checking.

Price Deregulation: The removal of restraints on the rates that depository institutions may pay to obtain deposits or may charge on their loans. Most restraints were removed by the Depository Institutions Deregulation Committee acting under the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Depository Institutions Act of 1982. Usury ceilings on the rates charged by depository institutions have been relaxed but they are still binding in some states.

Product Deregulation: The removal of restraints on the types of financial services that depository institutions may offer; in particular, the Glass-Steagall Act (1933) that prohibited commercial banks from engaging in investment banking activities and underwriting securities.

Regulation Q: The Federal Reserve regulation that limited the interest

rates paid by member banks for deposit funds. More generally, Regulation Q is often used to mean deposit rate ceilings for all depository institutions. The power to set such deposit rate ceilings was delegated to the Depository Institutions Deregulation Committee by the Depository Institutions Deregulation and Monetary Control Act of 1980. By late 1983, almost all deposit rate ceilings had been removed, with the exception of low denomination, short maturity time and savings accounts and demand deposits (which are legally prohibited from paying any explicit interest.)

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Donald R. Fraser is the Dresser Industries Professor of Finance at Texas A&M University. His teaching responsibilities include undergraduate and graduate courses in financial management, financial institutions and financial markets. Prior to joining Texas A&M in 1972, he was employed by the Federal Reserve Bank of Dallas and by Bell Telephone Laboratories. He has also taught at the University of Arizona, where he received his Ph.D. and at the University of Texas at El Paso. He has extensive consulting experience, primarily with commercial banks and bank holding companies, as well as substantial experience in Executive Development Programs offered by Texas A&M. His over 100 articles have appeared in the Journal of Finance, *the* Journal of Financial and Quantitative Analysis, *the* Journal of Financial Research, *the* Journal of Bank Research, *as well as in other finance and business publications. In addition, he is the author of four books,* Financial Institutions, Financial Institutions and Markets in a Changing World, The Financial Marketplace, *and* Money, The Financial System and Economic Policy. *Dr. Fraser has been honored on four separate occasions for outstanding research by the College of Business Administration at Texas A&M, and has been awarded Graduate Faculty Research Fellow status. In addition, he was selected for a Texas A&M University Faculty Distinguished Achievement Award in Teaching during the 1979-80 year. He served as visiting scholar at the University of Sussex, England, from January-May, 1982.*

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